2005 FORECAST
UTAH TAXABLE SALES

2004 SUMMARY

Following three years of near zero growth, Utah taxable sales will rise about 8 percent in 2004.[1] Last year, following 2001 through 2003 years of near zero growth, we were hesitant to believe our models, which suggested taxable sales would rise 6 percent or more. The 8 percent estimate for 2004 is more than double the 3.2 percent gain, which we targeted last year. Continually improving job gains throughout the year, a booming construction sector, as well as the rebound in U.S. and subsequently Utah business investment spending worked together to jump-start taxable sales. First half growth of nearly 9 percent compared favorably to the Iraq war quarter spending in 2003. For the year, we expect taxable sales will grow 8 percent, the best growth since 1996. Relatively low mortgage rates, ample supplies of lending money, improved hiring and, except for energy prices, mild gains in the core CPI – all these factors led to improved consumer confidence in early 2004. In 2005, interest rates will rise and the spread between long-term and short-term rates will narrow from 300 to 200 basis points, putting downward demand and supply pressure on residential building. These negative factors will be offset somewhat by steadily improving job prospects and lower energy prices. Taxable sales will grow 5.3 percent in 2005, slightly less than the 5.8% estimate for non-agricultural wages and salaries. The following list some of our concerns with this forecast:

1) Job growth and average wages have improved markedly of late, but will these gains continue into 2005?
2) Corporate profits are beginning to tail off, possibly narrowing future business investments.
3) Over the past few years, cheap, high-quality imported goods from China and other Southeast Asian countries have lowered goods inflation, effectively cutting into nominal dollar taxable sales growth.
4) Any major terrorist attacks will cast another shadow on consumer and business confidence.
5) Finally, mounting Internet purchases by Utah consumers will cut the sales tax base by 3% in FY2006.

Taxable sales can be dissected into three major components:

1) **Retail Trade** at $20.3 billion, which represents about 57% of taxable sales, will grow 8% in 2004, the fastest rate since 1996, about three times higher than expected last year, and ahead of ten-year average of 5.3%. Retail trade will grow slightly more than 5 percent in 2005.

---

1 Taxable sales consist of final sales of most tangible personal property in the state. Taxable sales of selected services such as hotel and lodging, automobile leases, amusements and repairs to tangible personal property are also taxable in Utah.

2) **Taxable Business Investment and Utility Sales,** which, at $8.9 billion, represents slightly more than 25% of taxable sales, will grow nearly 13% in 2004. We expect this growth rate to slow down to a 4 percent in 2005.

3) **Taxable Services**, at $4.6 billion, will rise about 5% in 2004. Taxable services comprise 13% of taxable sales. This gain is the first increase since 2000, when business services were expanding to meet Y2K demands for software and hardware. Taxable Services will grow 7% to 10% in 2005 as business services begin to improve.

Retail Trade. The Utah consumer has kept taxable sales going pretty strong since 1990. Despite two wars and a terrorist attack, consumers, aided by ample supplies of money from the Federal Reserve and financial flexibility through increased use of home-equity loans and credit cards have increased retail trade sales between 2.5% and 11.5% from 1990 through 2004. The lowest two years, 2001 and 2003, where Retail Trade growth slipped to 2.5 percent were either years of terrorist attack or war. Retail Trade sales will rebound nicely in 2004 to a near 8 percent rate. Through the first nine months, sales rose 8.5%. Generally, people spend most of what they earn. Over the past 10 years Retail Trade sales have grown 5.5% per year, 1.4% less than Utah non-agricultural wages and salaries, which rose 6.9% per year. This may be due in part to increased purchases by savvy consumers of nontaxable sales on the Internet.

Retail Nondurable Goods. Nondurable goods sold by retailers are classified into the following sectors: General Merchandise, Food, Apparel, Eating and Drinking and Miscellaneous Shopping Goods stores. At $12.76 billion in 2004, Nondurable Retail sales represent 36 percent of all taxable sales. In 2004, sales in this sector will grow between 6% and 8%. Nondurable goods sales rose 8% in the first quarter, partially due to a comparison with the early 2003 Iraq war effect on consumer confidence. In the second quarter these sales rose almost 7 percent over 2003. In the third quarter, Nondurable store sales rose about 8 percent. The largest sector within Nondurable Goods Retail Trade, General Merchandise store sales, whose big-box discount stores are taking market share not only from traditional Department stores, but also from Grocery and Miscellaneous Shopping Goods stores, will see gains of at least 7% in 2004. Through the first nine months of 2004, Department store sales were up nearly 10 percent, while Variety store sales jumped 23 percent. Retail Apparel stores, which typically follow General Merchandise store growth patterns, will grow 6% to 9% in 2004. This is a strong (real dollar) gain, since clothing and shoe prices were flat in 2004. Food store sales, which have been meeting stiff competition from big-box discount department stores, fell three years in a row from 2001 through 2003. These sales should increase at least 2% in 2004, slightly lower than the 2.9 percent rise in food prices. Restaurant sales bounced back nicely from three years of 2% to 3% growth by rising 9% in 2004. Fast-food, Family and White-Tablecloth restaurant sales will all rise more than 10%. Theme restaurant sales appear to be flat in 2004. Following modest 3%, 6% and 3% respective gains in 2001, 2002, and 2003, Miscellaneous Shopping Goods store sales will improve 9% in 2004. Intense competition from big-box discount Department stores as well as Internet sellers cut into sales at these stores. But the apparent return of out-of-state skiers and other tourists, as well as improving local economic conditions, bodes well for them.

Barring another Middle-East war or major terrorist attack, Nondurable Retail sales will be up 5% in 2005, partially due to comparisons with a strong 2004, rather than the war-plagued year of 2003. In the U.S., Global Insight is predicting that the 7.5% Nondurable sales gain in 2004 will slow down to 3.7% in 2005.

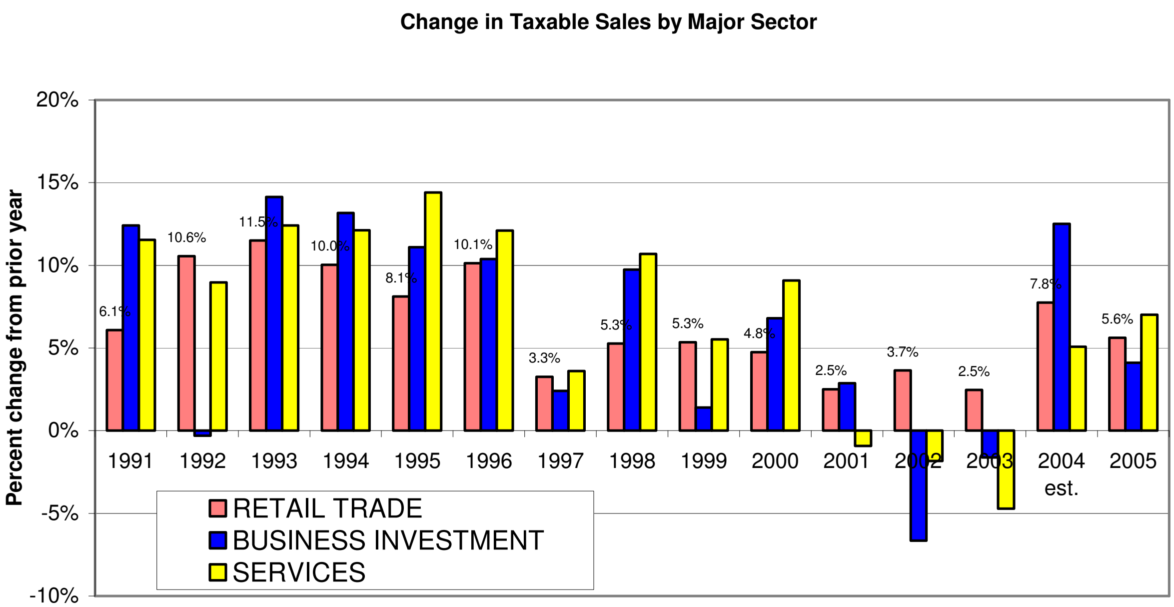
<u>Retail Trade - Durable Goods</u>. Retail Durable goods stores are those where the majority of sales come from items that last three years or more. We track three broad sectors: Building and Garden stores, Furniture stores and Motor Vehicle Dealers. These sectors are usually impacted by: 1) changes in the housing starts, 2) movements in interest rates and 3) job growth. All of these conditions were ripe in 2004, boosting sales to grow 10%. Residential construction values, which will rise 12% in 2004, bolstered hard-good sales. Building and Garden store sales will jump nearly 26% in 2004. Lumber store sales will rise nearly 30% and hardware store sales (including some big-box types) will be up 18%. Nursery store sales were also up in double-digits. All of these strong growth rates will be difficult to eclipse in 2005, especially if housing permits recede from 2004 peak levels.

After homes are built, they must be furnished. Furniture and Home Furnishing store sales will see gains of almost 10% in 2004. Electronic and computer store sales should also grow slightly less than 10% in 2004. Declining sales are apparent at record and music stores. Expect weaker Furniture store sales here in 2005, especially if residential construction values begin to tail off due to higher mortgage rates and tighter monetary conditions.

Despite an 8 percent gain in unit sales of new cars and light trucks, Motor Vehicle Dealer sales growth will be up less than 4% in 2004. The dramatic jump in gasoline prices have made large, expensive SUV purchases less attractive, which lowers the average new car sale value, and hence gain in taxable sales. In fact, despite the 8 percent rise in new car and light trucks in 2004 to almost 100,000, New car dealer sales volume was up only 3% during the first three quarters compared to a year earlier. Used (only) Car Dealer sales were down 3% in the first nine months. Boat Dealer sales will be up about 9% in 2004, in part, perhaps, due to Utah's replenished reservoirs. Again, retiring baby-boomers and low interest rates enabled strong growth for both Recreation and Utility Trailer and Motorcycle (including ATVs and snowmobiles) Dealers, up 17% and 13%, respectively in 2004. Unit sales of New and Used Car Dealers should be fairly flat in 2005, close to 100,000. If gasoline prices recede, as expected, perhaps consumers will switch back to the more expensive SUVs and trucks that they preferred in the past, bolstering taxable sales.

Business Investment and Utility Sales. This category includes taxable business-to-business (B2B) purchases of supplies and equipment and business-to-consumer (B2C) sales of utilities and final sales at wholesale trade stores. In 2004, these sectors will comprise 25% of all taxable sales (down from a peak of 27% in 2001). Almost 15% are found in goods-producing sectors of Agriculture, Mining and Manufacturing and their Wholesale Trade counterparts, while 10% of taxable sales are in the service producing sectors: Transportation, Communication, and Public Utilities. Business investment purchases began to decline during the fall of 2001 due both to recession and the 9-11 Terrorist Attacks. Investment fell in 2002 and 2003 as the nation struggled with both recession and war issues.

Figure 1.



The 13% gain in U.S. fixed investment for equipment and software in 2004 fueled Utah business investment as well. With the end of bonus depreciation in view, Utah businesses have picked up their investment purchases by nearly 14 percent over 2003. Mining purchases will be up 50% in 2004, in part due to the end of bonus depreciation, but also due to the stimulus of higher copper, oil and gas prices. Both Manufacturing and Construction purchases will be up more than 20 percent in 2004. Transportation sector purchases will be up more than 30 percent in 2004 with purchases by airlines growing more than 70 percent.

Communications sales and purchases will be mixed in 2004: Mobile telephone companies reporting 12 percent sales growth, while land-line companies facing a 4 percent drop in sales. In addition, the Legislature exempted cable and satellite TV services beginning July 1, 2004, causing taxable sales to drop by $150 million in 2004 and by $300 million in 2005.[2] Electric services will be up about 6 percent in 2004, but natural gas sales and purchases will be down 3 percent. Final sales by Utah's Wholesalers will be up, especially for the durable goods sellers, who sell to the Mining, Manufacturing and Construction sectors. Hard goods Wholesale sales will be up about 18 percent in 2004. Nondurable Wholesale goods store final sales should approach 10 percent in 2004.

The outlook for Business Investment and Utility sales in 2005 foresees a 4 percent increase over 2005. The July 1, 2004 exemption of cable and satellite TV services will decrease 2% off an otherwise 6% gain in 2005. In addition, U.S. Investment in Software and Equipment will ratchet down from 13% to 9% in 2005. And, bonus depreciation ends on December 31, 2004. Finally, the boost from comparing to a very weak Iraq war period will not be there, in fact, just the

2 The Legislature recaptured these sales by creating the Multi-channel Video or Audio Service Tax.

opposite, we will be comparing to near 13% growth of 2004. If oil and copper prices recede as foretold by future prices, Business Investment may not reach the 4% forecast. Expect taxable Business Investment purchases and Utility sales will range between $9 billion and $9.3 billion in 2005.

Taxable Services. This sector is an eclectic mix of Utah consumer spending on amusement and personal and financial services, tourist spending for Utah's hotels, resorts and rental cars and business and consumer (B2B and B2C) spending on computers and equipment. Driving this sector in our models are permanent Utah wages, Salt Lake City International Airport arrivals and departures and U.S. business spending on software and equipment.

Between 1990 and 2000, Taxable Services rose more than 9% in eight out of the 11 years. The streak ended abruptly in 2001 with the 9-11 Terrorist Attacks, which crippled tourism, and the end of the year 2000 (Y2K) buildup, which had fueled business services in the 1990s. Taxable Services declined for three straight years from 2001 through 2003.

Finally, in 2004, this sector began to grow. The tourist portion of taxable services has improved markedly. Hotel sales will be up 6% to 8% in 2004. Amusement and Recreation sales will rise between 5% and 7%. Auto rentals are up 10%. And Motion Picture Theater sales will be up 14% in 2004.

The business portion of Taxable Services will be mixed. Purchases by the Legal, Social and Engineering companies are up in double-digits, while Education sales will be flat. Auto repairs will be up near 5% in 2004. Within the Business Service sub sector, Computer and Data Processing Service company sales will drop 6%. The big Miscellaneous Business Services sub-sector will see sales growth of 9%.

Our modeling suggests there may be pent-up demands for Taxable Services in 2005 and that a 10% gain is possible if wage growth, tourism and business services are positive in 2005. We think taxable services will grow from 4% to 10% in 2005, to $4.9 billion, past the 2000 peak of $4.75 billion.

Sales Forecast and Other Public Policy Issues. Several issues affect this very important tax base for Utah state and local governments. In some cases the impacts are not independent of each other. The manner in which these issues are resolved may affect how taxable sales are reported or if they are reported at all.

1. **9/11 Impact on Taxable Sales.** Until 2004 the economic impact from the 9-11 Terrorist Attacks effect on tourism, transportation and investment depressed taxable sales about 2.3% per year, by $810 million in taxable sales and hence by $38 million in state sales taxes and more than $14 million in local sales taxes. In our 2005 sales tax forecast, this negative impact is cut in half.

2. **Internet Sales**. Given the fact that surveys find Utahns in the top ten among Internet users and PC purchasers, the inability to tax remote sales is a big issue with respect to the

sales tax base. Dr. William Fox et al from University of Tennessee estimated that Internet sales would cost Utah about $55 million in state and local sales taxes by 2004 and about $192 million in 2006.[3] Based on recent quarterly surveys at the U.S. Department of Commerce we calculate the loss will amount to 3% of state sales taxes ($53 million in fiscal year 2006).[4] Local sales tax losses of $17 million are expected for fiscal year 2006.

3. **Zoning for Dollars.** Much study and discussion of late has occurred with respect to the attempts by local government to build up their respective tax bases by luring big-box discount stores into their cities with direct and indirect subsidies. One insight was made during 2004 discussions that brought to light the importance that the two-decade old "¾ of 1% hold harmless" provision still has for about 15 major cities. This provision effectively discourages them from moving towards a more population-driven distribution system.

---

3 Donald Bruce and William Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," University of Tennessee, September 2001.

4 Commerce reported Internet B2C retail sales amounted to between 1.7 and 1.9% of total retail sales during the first three quarters of 2004. E-commerce sales were 0.8% of total sales in the second quarter of 2000. See www.census.gov/mrts/www/current.html.